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NO. 756

IN THE

Supreme Court of the United States

October Term, 1965

HENRY DAVID and wife, GRACE DAVID, *Petitioners*

v.

ROBERT L. PHINNEY, DISTRICT DIRECTOR OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI
To The United States Court of Appeals
For The Fifth Circuit

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Petitioners Henry David and wife, Grace David, pray that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit entered in the above entitled case (No. 20941 below).

CITATION TO OPINION BELOW

The Opinion of the Court of Appeals for the Fifth Circuit, printed in Appendix A hereto, is reported at 350 F.2d 371. The findings of fact and conclusions of law of the District Court (not reported) are printed in Appendix B hereto.

JURISDICTION

The Judgment of the Court of Appeals for the Fifth Circuit below, finding no reversible error and affirming the judgment of the District Court, was dated and entered July 21, 1965. A Petition for Rehearing was filed with the Court of Appeals for the Fifth Circuit within the appropriate time limits. Such Petition for Rehearing was denied by the Court and entered on August 26, 1965, without opinion. Jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

It has long been settled as a matter of administrative policy that a determination by the Commissioner of Internal Revenue regarding assessments for deficiencies in taxes are presumptively correct, thereby placing the burden of proof upon the taxpayer to prove the Commissioner's determination to be erroneous.

The questions presented in determining whether Petitioner has stated a claim upon which relief can be granted are:

1) Whether, after seven different and independent determinations at varying times are advanced by the Commissioner of Internal Revenue, as to the tax consequences of one transaction, the Commissioner's presumption of correctness remains in full force and effect, thereby placing the burden of proof on the taxpayer to disprove each of these "determinations", when:

   (a) The very fact of the multitude of determinations or theories advanced by the Commissioner shows

that at least six and most probably all seven of his determinations as to the taxability of this transaction are incorrect?

(b) The great number of positions taken by the Commissioner show that his actions in regard to this taxpayer and this transaction are arbitrary, excessive and capricious?

(c) The Commissioner makes one last effort and again changes his position on the Courthouse steps before trial and attempts to keep the burden on Petitioners simply because his new theory is discussed and recorded as an issue in a pre-trial conference?

2) Whether, as a matter of good policy for all taxpayers and litigants, the Courts should afford the Commissioner of Internal Revenue the overwhelming power of assessing and collecting taxes by fiat by allowing any determination he makes at any time to be presumptively correct?

3) Whether the Commissioner of Internal Revenue and the Courts below can insert a covenant not-to-compete and an option held for less than six months or any other matter they dream up into negotiated and bargained for items in a contract between the Petitioners and a third party, when the clear, unimpeached testimony of credible witnesses in the case states that those items were never bargained for or considered to be a part of the negotiated sales price?

4) If a suit for refund of Federal Income taxes paid is in the nature of an action for money "had and re-

ceived", as the Commissioner has asserted in this case, should the Petitioners have the burden of proving that at least some taxes were due, or do not the Petitioners, as they have done in this case, have the alternative of proving that absolutely *no* taxes were due as the result of this transaction?

STATUTES AND REGULATIONS
INTERNAL REVENUE CODE OF 1954:

"Sec. 61. Gross Income Defined.

(a) General Definition. — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;"

"Sec. 1221. Capital Asset Defined.

For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, * * *"

(4) accounts or notes receivable acquired in the ordinary course of trade or business * * *.

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, * * *"

"Sec. 1222. Other Terms Relating to Capital Gains and Losses.

For purposes of this subtitle—

(1) Short-Term Capital Gain. — The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income."

"Sec. 1234. Options to Buy or Sell.

Gain or loss attributable to the sale or exchange of, or loss on failure to exercise, a privilege or option to buy or sell property which in the hands of the taxpayer constitutes (or if acquired would constitute) a capital asset shall be considered gain or loss from the sale or exchange of a capital asset; and, if the loss is attributable to failure to exercise such privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired. This section shall not apply to losses on failure to exercise options described in section 1233(c)."

Treasury Regulations

"§1. 167(a)-3 Intangibles

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted

merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowed with respect to goodwill. * * *"

STATEMENT OF THE CASE

The taxpayer, in this case, Henry David (his wife is joined as a party because a joint return was filed for the year ended December 31, 1956) hereinafter referred to as "David" or "Petitioner," was associated with Milwhite Company, Inc., hereinafter referred to as "Milwhite," in various capacities from 1939 to 1952 (R. 119, 120). Milwhite was a company engaged in the mining, manufacturing and supplying of various minerals that are used as drilling mud in oil and gas wells.

In 1952, Milwhite and David joined in the organization of Milwhite Mud Sales Company, hereinafter called "Mud Sales," as a sales company for drilling mud and related products (R. 119, 120). David was one of the most outstanding people in this field and became the key man in Mud Sales operations (R. 49). By 1955, Mud Sales owed the Texas National Bank approximately Seven Hundred Fifty Thousand Dollars ($750,000.00) and owed Milwhite some Five Hundred Sixty-One Thousand Dollars ($561,000.00), but was still short of necessary working capital. (R. 20, 22).

In Mid-1955, Mud Sales business had expanded to such an extent that it was necessary for Mud Sales and its owners to find a new method for financing its operations. The final decision was to try to sell Mud Sales to an outside organization that would be in a position to provide sufficient funds for its ever-expanding business (R. 120, 121).

At this time, Mud Sales had 6000 shares of common stock issued and outstanding of which Milwhite owned 3000 shares, David and his wife owned 2000 shares, and David as guardian for his minor children owned 1000 shares (R. 119, 250).

Negotiations were then begun with W. R. Grace and Company for the sale of Mud Sales but the Grace Company did not purchase Mud Sales (R. 123-126).

Financial advisers then told David that in order for him to carry on future negotiations with a prospective purchaser of this organization, he would have to be in some position of assuring the buyer that he could deliver all of the stock of Mud Sales (R. 126). Accordingly, on December 2, 1955, Milwhite granted an option to David to purchase the 3000 shares of Mud Sales stock owned by Milwhite for $1,000,000 plus accrued net worth (R. 124-128, 247, 248).

Meanwhile, Mississippi River Fuel Corporation, hereinafter referred to as "Mississippi" learned that Grace had decided not to purchase Mud Sales. John Bolinger of Mississippi informed David that Mississippi was interested in acquiring Mud Sales (R. 128). After several preliminary discussions were completed, final negotiations took place between David and the representatives of Mississippi in Palm Beach, Florida (R. 129) in January of 1956. It was at this meeting that a purchase price of $500,000.00 plus accrued net worth for 1000 shares of David's stock in Mud Sales was agreed upon by the parties (R. 131) After a brief exchange of written contracts between the attorneys for the parties, a written agreement was signed for the sale of the stock based on the terms worked out in the Palm

Beach meeting, plus some additional matters inserted by the attorneys for the parties (R. 249).

Mississippi then independently negotiated with Milwhite (R. 145) for the purchase of its stock in Mud Sales and reached an agreement by which Mississippi would purchase the 3000 shares of Mud Sales stock owned by Milwhite for $1,000,000.00 plus accrued net worth (R. 133) and would arrange for payment of the indebtedness owed by Mud Sales to the Texas National Bank and Milwhite (R. 134). In addition, there was a provision for an exclusive sales representation contract between Milwhite and Mud Sales (R. 134). On a per share basis, David received some $166,000 more for his 1000 shares of Mud Sales stock than Milwhite received for each of its 1000 shares of Mud Sales stock, but David did not receive the benefits that Milwhite received referred to above.

David and his wife filed their joint tax return for 1956 in which the excess of what David received over his basis in the stock of Mud Sales was reported as long-term capital gain. The Commissioner of Internal Revenue picked a figure of $125,000.00 and made a deficiency assessment to the effect that $125,000.00 was paid to David for the sale of the option that David had obtained from Milwhite and that the option had been held for less than six months thereby constituting short-term capital gain (R. 95-98). David paid the alleged deficiency, made his claim for refund and then brought this suit. Jurisdiction was conferred on the District Court by the provisions of 28 U.S.C. § 1346(a).

It was *after* this suit had been filed and the Commissioner had filed his answer in the suit that the vacillating positions of the Commissioner began. The independent and mutually

exclusive positions taken by the Commissioner *after* his original determination, *after* the tax was paid, *after* the suit was filed and *after* the answer of the Government was filed were as follows:

Occasion	Government's Position	Reference
1. Deficiency Assessment	$125,000 received for option	(R. 95-98)
2. Pre-Trial Order (November 20, 1961)	$125,000 or some lesser amount received for option	(R. 172-173)
3. Pre-Trial Order (November 20, 1961)	$125,000 or some lesser amount received for covenant-not-to-compete	(R. 172-173)
4. Pre-Trial Order (November 20, 1961)	$125,000 or some lesser amount received for covenant and option	(R. 172-173)
5. Respondent's Pre-Trial Memorandum (April 15, 1963)	Portion of $629,226.75 paid to David for covenant	(R. 175-176)
6. Respondent's Opening Trial Argument (April 17, 1963)	$125,000.00 exactly (not lesser amount) paid to David for option and covenant	(R. 11, 12)
7. Respondent's Brief in Fifth Circuit (June 8, 1964)	$125,000.00 paid to David as Bonus or Additional Compensation	(BR. 17)

Without any evidence in the case on the $125,000.00 figure of the Commissioner, the District Court nonetheless entered judgment for the District Director. Jurisdiction for the Court of Appeals for the Fifth Circuit was conferred by 28 U.S.C. § 1291.

ARGUMENT

A. THE LOSS OF THE COMMISSIONER'S PRESUMPTION IN THIS CASE.

The Commissioner's determination upon which the tax was paid and this suit was filed was that $125,000.00 was

received by David for an option held for less than six months. This determination is presumptively correct unless something is done by the Commissioner to destroy the presumption or unless the taxpayer proves the Commissioner to be in error.

The determination made in this case consists of two elements:

1) A theory determination - David received payment for the option; and

2) A value determination - the payment he received was in the amount of $125,000.00.

What happens to the Commissioner's determination when he interjects new theories into his case but remains with the same value? His inconsistent positions become an impossibility insofar as keeping the same theory is concerned. If the Commissioner has determined that option equals $125,000.00 then it is impossible for the later position of option plus covenant equals $125,000.00 to be correct. One of the positions taken must of necessity be incorrect.

It is apparent that the Commissioner simply decided that a portion of this money David received should be taxed at ordinary income rates. After finding that his initial determination could not be substantiated, the Commissioner went searching for other theories and came up with seven. If he is going to advance these new theories, the Courts should require him to prove not only the existence of the theory but also the value to be put on it; otherwise, David would have a burden placed on him that would be impossible to overcome. The Commissioner should not be permitted to prevail in a lawsuit on the basis of a lost presump-

tion, especially when he produced no witnesses and offered no evidence in the case. The Government's whole case was based on a doubtful mathematical computation and nothing more. Certainly, the taxpayer's witnesses did not testify that anything of a value of $125,000 was separately bargained for by the parties.

Furthermore, the many positions advanced by the Commissioner in this case shows that his actions were abritrary, excessive and capricious toward David as a taxpayer. An overstepping of administrative authority to the detriment of this taxpayer is very clear, thus calling for judicial action. This reason simply adds more fuel to the argument that the Commissioner should prove this theory and value in the case when his actions are clearly prejudicial to the taxpayer.

Of course, just because some of these new theories were discussed in pre-trial hearing should not change any of the rules as regards the Commissioner bringing up new matters and having to prove them. The pre-trial hearing and order served the purpose of putting the Commissioner's issue that a covenant-not-to-compete was part of the $125,000.00 into the case. The Commissioner had the burden on this issue, both as to theory and as to value. As a covenant-not-to-compete was inserted in the written contract of the parties, the Commissioner may have some theory points in his favor. His case again totally fails for proof of value. Not only does his case fail because of this lack of proof on value, the taxpayer's unimpeached witnesses testified that there was no value ascribed to either the covenant or the option. The mathematics and many surmises of the Commissioner certainly must not take precedence over such testimony.

However, the Court of Appeals for the Fifth Circuit tries to decide the case without deciding this issue, as it states that the Government should win even if it had the burden of proof. The dichotomy shown in the foregoing argument demonstrates that it was impossible for the Government to win with no evidence in this case on value. The very decision of the Court that the option plus the covenant equals $125,000 shows that it too was relying on a figure plucked from the air by the Commissioner, a figure once presumptively correct as to being the value of the option, but of no force and effect whatever since it now comes up to be equal to the option plus the covenant.

This Court must decide the issue as to when the presumptive correctness of the Commissioner's determination is lost in order to correctly decide this case.

B. THE PRESUMPTION ISSUE MATERIALLY AFFECTS ALL TAXPAYERS IN ALL CASES.

The dilemma that the taxpayer was in after the multitude of erroneous positions were advanced by the Commissioner in this case has been demonstrated, together with the reasons why the Court should reverse this case in David's favor. The major question that remains is whether this Court should decide this important question of Federal law for any other reason under the guidelines that it has set forth in Rule 19 of the Supreme Court Rules.

This issue must be decided if this nation is to have a tax system that is to be fairly administered while retaining its self-assessment character. Petitioner does not take issue with the rule of presumptive correctness when the Commissioner has made a determination and has consistently applied that determination throughout a controversy.

Rather, the main issue for this Court to decide is whether the Commissioner, by his own actions, can lose his presumption by continually changing his determination. Petitioner urges that the Commissioner must come to trial without the presumption in such a set of circumstances. To allow the Commissioner to retain this valuable position after constant misuse is tantamount to allowing the Commissioner to assess and collect taxes by fiat.

The facts of this case supply a startling example of overuse and misuse of such a power. Having ascertained at various points during this controversy that his present position was untenable, the Commissioner simply "changed horses" from time to time and tried to put the burden on David to disprove every theory that was being advanced. It is presented to this Court that there are probably thousands of different theories by which David or any taxpayer could be taxed at ordinary income rates. All the Commissioner would have to do is pick one theory after another until one came up that the taxpayer could not disprove. The Commissioner would then be assessing and collecting taxes with a waive of the hand over his multi-theoried arsenal and a random choice out of his prodigious grab bag.

Taxpayers must be advised of what the "charge" is against them in a tax suit since they have the burden of disproving that charge. One can hardly disprove something that he does not even know of or something that is likely to change completely six or seven times during a controversy.

Petitioner concedes that the Commissioner should be given the benefit of the presumption if used correctly.

On behalf of all taxpayers, Petitioner urges this Court to protect the rights of these taxpayers and not allow the Commissioner to assess and collect taxes when he has so greatly overstepped the bounds of fair dealing in using this presumption.

Cases have been decided in which the Commissioner loses this presumption and must prove his case. *Massingale v. U.S.*, 3 A.F.T.R. 2d 995 (D. Ariz., 1959); *Service Life Insurance Co. v. U.S.*, 189 F.Supp 282 (D. Neb., 1961), aff'd. 293 F.2d 72 (Ca 8th 1961); *Hull v Commissioner*, 87 F.2d 260 (4th Cir., 1937); *Estate of William Beale Hibbs*, 16 T.C. 535 (1951); *Sheldon Tauber*, 24 T.C. 179 (1955). These cases are well reasoned and the Court should follow them.

C. CONFLICT BETWEEN CIRCUITS ON INTENTIONS IN BARGAINING.

After the purchase price was agreed upon for the sale of David's stock in this case, a written contract was drawn up and signed by the parties. This contract contained a provision that assigned the December 2, 1955 option and likewise contained a covenant-not-to-compete for David (R. 249-257).

At no time during the negotiations was there any mention of the December 2, 1955 option. At no time during the negotiations was there any discussion of a covenant-not-to-compete (R. 47, 49, 141, 143, 148, 149). A memorandum written by David to his attorney, which outlined the agreement reached in Florida made no mention of these items as part of the bargain (R. 238). The District Court and the Court of Appeals for the Fifth Circuit nevertheless decided that those were valuable items and

the Commissioner's value of $125,000.00 should be assigned jointly to them. Nothing further need be said as to the incorrectness of $125,000.00 figure that the Commissioner arbitrarily picked.

In this case, the lower Courts apparently based their respective decisions on the fact that these parts of the written contract as to the covenant and the option had some value even though the parties did not intend or did not in fact ascribe any values to these items.

The Court of Appeals for the Ninth Circuit in the well-reasoned opinion of *Annabelle Candy Co. v. Commissioner*, 314 F.2d 1 (C.A. 9, 1962) has correctly stated the issue to be one of intention of the parties as being indicative of the actualities of the bargain and what was being bought and sold. If the parties intend that some part of the consideration is being paid for a particular item, then this intention should control. If there is no such intention, then there is no feasible basis on which part of the consideration can be allocated. Certainly, the whim of the Commissioner should not be allowed to come in and rearrange an otherwise valid and binding way of completing a transaction.

Beyond the obvious conflict between the Circuit Courts on this issue, this Court should decide this particular point as a matter of guidance for all taxpayers in all types of dealings. Taxpayers, in the absence of some type of sham transaction, should be able to rely on the deal they have made and the attendant tax consequences that flow from such a deal. As in this case, if a party has bargained for the sale of one item (stock), then he should be taxed according to the terms of his bargained transaction. The

after-tax dollar that David would receive from this transaction was certainly the most important criterion from his standpoint. If superfluous matters are included in a written contract, these matters should not change the bargain of the parties. Furthermore, the Commissioner should not change that bargain on the basis of what he thinks the parties should have bargained for and then arrive at some figure that he thinks should have been part of the bargain.

This is not a case in which a group of assets are sold in bulk and the consideration flowing must be assigned to those assets. Rather, one item was sold here; that item was David's stock in Mud Sales.

D. MONEY HAD AND RECEIVED CONCEPT.

The Court below, in evading the issue on presumptive correctness and burden of proof, stated that an action for refund of taxes paid is in the nature of a common law action for money had and received and that the taxpayer must prove what is due him. Without taking issue with whether this doubtful principle or its application is correct, the taxpayer in this case still met that burden. A decision in favor of the taxpayer on the other two broad issues heretofore presented to Court offers no other conclusion than that the Commissioner's value was incorrect and that the option and covenant were not bargained for and really had no value to the parties. If this be the case, the Petitioner has proved that he was entitled to all the tax that was erroneously assessed; the Petitioner proved that he was paid for his stock and that alone and not something dreamed up in the mind of the Commissioner.

This so-called concept of having the taxpayer produce evidence from which a proper determination can be made

does not place any burden on him to show that at least some taxes were due over and above what he paid. Rather, David demonstrated that no further taxes were due from him and therefore he should recover all that which was paid.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

DATED: November 15, 1965.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This will certify in conformance with Rule 33-2(a) and 3(b) of this Court that a copy of this Petition for Writ of Certiorari was placed in the United States Mail, postage prepaid this 17th day of November, 1965, properly addressed to the Counsel for Respondent as follows:

Hon. Louis F. Oberdorfer
Assistant Attorney General,
Tax Division
Department of Justice
Washington, D.C.
Attention: J. S. Cohen

Solicitor General
Department of Justice
Washington, D.C.

FENTRESS BRACEWELL

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 20941

HENRY DAVID and wife, GRACE DAVID,
Appellants,

versus

ROBERT L. PHINNEY, District Director of Internal Revenue,
Appellee.

Appeal from the United States District Court for the Southern District of Texas.

(July 21, 1965.)

Before RIVES and BROWN, Circuit Judges, and HANNAY, District Judge.

RIVES, Circuit Judge: The District Director of Internal Revenue made a deficiency assessment against the taxpayers[1] for income taxes for the year 1956 in the sum of $49,566.99 plus interest. The taxpayers paid the amount

[1] Grace David, the taxpayer's wife, is a party hereto solely by virtue of the fact that she filed a joint return with her husband for the taxable year ending December 31, 1956.

of said assessment and, their claim for refund having been denied, filed this suit. The complaint alleged that "in February 1956, Mississippi River Fuel Corporation paid Henry David $629,226.75 for the 1,000 shares of Milwhite Mud Sales Company stock, which he had owned since 1952. That the sale thereof constituted a long-term capital gain and as such was taxable only as a long-term capital gain." The complaint further alleged that the taxpayers' claim for refund was "based upon refusal of the Commissioner to allow 100% of the amount received from Mississippi River Fuel Corporation for the sale of 1,000 shares of Milwhite Mud Sales Company stock to Mississippi River Fuel Corporation." In a pretrial order signed by the attorneys for both sides, as well as by the district judge, the issues to be tried were agreed upon and stipulated. After a full trial and the consideration of briefs, the district court entered its findings of fact and conclusions of law, followed by judgment for the defendant. The plaintiffs' motion for new trial and for amended findings and conclusions were denied, and this appeal followed:

In entering its findings of fact and conclusions of law, the district court further refined the issue as follows:

> "The question presented is whether money received by the plaintiffs from Mississippi Fuel Corporation in 1956 included payment for an option to purchase stock and a covenant not to compete in addition to the actual purchase price of the stock."

Milwhite Company, Inc., hereinafter called Milwhite, was a miner, manufacturer, and supplier of nonmetallic minerals used as drilling mud in the sinking of oil and gas wells. The taxpayer, hereinafter referred to as David,

worked as a salesman employee of Milwhite in 1938 and 1939. From 1940 to 1952 David acted on a commission basis as exclusive sales representative of Milwhite's drilling mud.[2] In 1952, at David's suggestion, and with Milwhite's financial support, a separate company was organized to handle the sales of Milwhite's drilling mud, known as Milwhite Mud Sales Company and hereinafter referred to as Mud.[3] David had already built a sales organization of some thirty-odd men, and after the incorporation of Mud, that organization was greatly expanded but continued to be based primarily on David's personal contacts and reputation in the industry. David was one of the most outstanding salesmen of drilling mud, and was the dominant personality and key man in Mud's sales organization. By 1955 Mud needed new capital for its expanding business for reasons well explained in David's testimony:

> "A. Well, we were greatly undercapitalized and we were expanding and doing more business than our capital justified and any little accounts receivable that was delayed in payment was a great strain on us. We were in jeopardy with the bank we were doing business with in that we had short term money which was an insufficient amount to expand the business and meet with the new amount of sales that were increasing daily. It got to the point to where we either had to do less business or sell the company."

David and a vice-president of Milwhite went to New York and negotiated with W. R. Grace and Company.

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[2] Milwhite also mined and manufactured products for different purposes, such as filter clay, which amounted to about 20 or 25 per cent of its total sales, and for which it had other sales agents.

[3] While Mud was Milwhite's exclusive sales agency, Mud also sold some other products which Milwhite could not supply.

Mud then had outstanding 6000 shares of stock, of which Milwhite owned 3000, David individually 2000, and David as guardian for his minor children 1000. A contract was entered into giving the Grace Company a ninety-day option to buy Milwhite's 3000 shares for $1,000,000 plus accrued net worth during the fiscal year, and also to buy the 3000 shares owned or controlled by David for the same price. The Grace Company made an exhaustive study and report of Mud, which emphasized David's leadership in the mud sales business, but Grace Company elected not to purchase.

David was then advised that any prospective purchaser of Mud would probably want 100 per cent of its stock. Accordingly, David secured from Milwhite a ninety-day option to purchase its 3000 shares for one million dollars plus accrued net worth. The option also contained a provision that the purchaser should take Mud's notes held by Milwhite at face value plus accrued interest. (Mud was amply solvent and there is nothing to indicate that its notes were worthless.) Those notes which aggregated some $594,000 had been subordinated to loans of $750,000 made by Texas National Bank to Mud.

Mississippi River Fuel Corporation, hereinafter called Mississippi, was familiar with the negotiations of the Grace Company for the purchase of Mud. After Grace Company declined to purchase, Mississippi contacted David and arranged a meeting in Palm Beach, Florida, in January 1956. There an agreement to sell control of Mud to Mississippi was reached on a "hand shake" basis.

As to David's option to purchase Milwhite's stock, Mr. Bolinger, who represented Mississippi in the negotiations, testified:

> "Certainly we weren't interested in 50 per cent of the company and we would never have gone as far in our discussion with Mr. David had we not assumed that he could turn over all of the stock if we wanted all of the stock. I don't recall any mention particularly was made, or any examination was made of any such option agreement. We just assumed he could control all of the stock. He said he could—or represented all of it. We were dealing with one person as if he owned all of the stock."

Mr. Bolinger further testified that he did not recall any money being specifically ascribed to the option. Nor did Mr. Bolinger recall any mention of a covenant by David not to compete, but "at the initial negotiations at which I was present it was just assumed that that was part of the deal." Mr. Bolinger further testified:

> ". . . He [David] was the key man in the company, the very dominant factor in this company, and in our opinion he was one of the most if not the most outstanding guy in this business. Certainly he was part of the price. I'm sure we wouldn't consider buying this company without his organization of the service company."

David also testified that there was no conversation about the covenant not to compete, that the entire amount he was to receive was for the purchase of 1000 shares of his Mud stock, and that absolutely nothing was paid for the option or for the covenant not to compete.

Upon David's return to Houston, he gave his attorney, Mr. Robinson, a memorandum of the negotiations, including the following:

"David has arranged to purchase Milwhite, Inc. stock totaling 50% in Milwhite Mud Sales Company to be purchased by Mississippi River Fuel on a price based according to the Grace formula, which was one million dollars as of April 30, 1955, plus the net worth increase of the sales company until the time of this sale. David agrees to sell 1/3 of his stock in the same company to Mississippi River Fuel, but on the basis of $1,500,000. as of April 30, 1955, plus the net worth increase from that date until the time of sale. This will give Mississippi River Fuel 66-2/3% of the mud sales and David 1/3 of same.

"As a means of keeping David in his present role of running the mud sales company, Mississippi River Fuel as (sic) offered the following proposition: In addition to this immediate purchase of his 1/3, they would like to have an option to purchase David's entire interest in the mud sales company at anytime within the next five years for the price of $2,500,000. By the same token, David is desirous of having the understanding that for some unforeseen (sic) reason, health, death, or otherwise, Mississippi River Fuel is obligating themselves to purchase the remaining David interest in the mud sales according to the formula on which he is selling his 1/3 interest.

". . . . . .

"David is also procuring from Milwhite, Inc. exclusive sales representation contract and also the irrevocable rights to use all Milwhite Mud Sales presently named products that has (sic) been used by either the mud sales company or Milwhite, Inc. . . .

"John, naturally, I will agree to diligently *prusue* (sic) this job just as I agreed to do for Grace on the basis of my present salary of $50,000. per year and all the other little things that need to be added to this agreement should be done at this time."

David's attorney prepared a draft of the agreement for submission to Mississippi, which included David's agreement to transfer to Mississippi the option of David to purchase Milwhite's 3000 shares in Mud and obligated Mississippi to exercise that option, but made no reference to any covenant not to compete on the part of David. Mississippi's attorney made a number of changes in the draft so prepared and returned to David's attorney a draft of the agreement which became the executed contract. That contract provides in part:

> "M. One of the considerations entering into the purchase price being paid and to be paid for all of said capital stock, is the good will attached to the operations of MUD SALES under the management of DAVID. Accordingly, as an essential part of this Agreement DAVID agrees not to engage in any business or activity in any way competitive with MUD SALES for a period of two (2) years from the date of purchase by MISSISSIPPI of said remaining 2,000 shares and in no event prior to February 1, 1961."

David's attorney testified that he advised David that in his opinion this covenant not to compete was not enforceable in the State of Texas. He further testified that, in his opinion, the maximum value of this covenant not to compete would be $2,500, the cost of legal expenses to defend against it. David testified that, when he observed this provision in the contract:

> "Oh, Robinson, and I talked it over and I told him that since I was involved in this new deal, involved as much as I was, that I had enough interest remaining in it that I certainly would have to remain in the

company to protect these particular interests and that I didn't particularly object to this because I had hopes of being with this and trying to make this one-third interest that remained in the company worth a lot of money for many years to come."

Mississippi's representative came to Houston and first closed the contract with David. In a separate meeting at which David was not present, Mississippi closed with Milwhite for the purchase of its 3000 shares substantially at the price and on the terms stated in the option from Milwhite to David. Upon the assumption that the payments to David and to Milwhite were solely for the purchase of their shares of stock in Mud, David received about $166,000 more for the 100 shares of stock which he sold than Milwhite received for each of the three 1000 shares which it sold. The Director did not allocate all of this difference to something other than the shares of stock, but averaged the prices paid for all 4000 shares, and allocated the portion in excess of the average selling price, or approximately $125,000.

The district court held that the written contract between David and Mississippi truly expressed the intention of the parties and showed that David intended to transfer to Mississippi not only his 1000 shares of stock in Mud, but also his option to purchase Milwhite's shares, which option he had held for less than six months, and David's own covenant not to compete. The district court further held that the total consideration for the contract must be allocated to its component parts, that a part of the consideration was paid to David for the assignment of his option to purchase Milwhite's stock, and a part for David's covenant not to compete. The court further held that

David had failed to offer any credible evidence that the tax was erroneously assessed or the correct amount of the tax due as a refund.

After a careful reading and study of the record, we do not find any material errors in the findings of fact made by the district court.

The district court declined to admit in evidence the Internal Revenue Service Agent's explanatory report delivered to the taxpayers as an explanation of the deficiency assessment, but nonetheless permitted the plaintiffs to show:

> "Q. What contention did he make, Mr. Robinson?
> A. The contention made by the agent was that $125,000 should be allocated, based upon the sale of the option and it should be a short term capital gain because based upon his statement the instrument of December 2nd had not been in existence for for more than six months."

With that explanation in the record, there would appear to be no prejudice from the exclusion of the Agent's report.

No explanation was offered to the district court of the claimed materiality of the report except that the agent did not make the point that a portion of the consideration should be allocated to the covenant not to compete. It is now urged that, since the theory that the taxpayers derived ordinary income from a covenant not to compete was not relied on in the deficiency notice, the defendant had the burden of proving the facts to support that theory.[4]

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[4] In support of that contention, the appellants cite: Massingale v. United States (D. Ariz., 1959), 3 Am. Fed. Tax. R.2d 995; Service

Assuming, without deciding that this is so, the facts were fully developed and showed a contract containing the covenant not to compete. Additional evidence, much from David himself, showed the high value which the purchasing parties put on his continued services and, conversely, his not being in a competitive position. The trial court, as a trier of facts, was entitled to find that this was a material element of the agreement and that a significant portion of the consideration received was attributable to it.

It should be noted also that the district court did not hold that *all* of the $125,000 allocated to something other than the shares of stock should be allocated to David's covenant not to compete, but only that a part should be so allocated and a part to the assignment of the option. Under that holding the rule stated in 10 Mertens Law of Federal Income Taxation §58A.35, pp. 98, 99, has application.

> "Since the action for refund of taxes is in the nature of a common law action for money had and received and is governed by equitable principles, the burden of proof is upon the taxpayer to prove not only that the determination of the tax was wrong, but to produce evidence from which another and proper determination could be made."

Life Insurance Co. v. United States (D. Neb., 1960), 189 F.Supp. 282, 6 Am. Fed. Tax R.2d 5481, aff'd (8 Cir. 1961) 293 F.2d 72, 8 Am. Fed. Tax R.2d 5135; Hull v. Commissioner (4 Cir., 1937), 87 F.2d 260, 18 Am. Fed Tax R. 758; Estate of William Beale Hibbs (1951), 16 T.C. 535; Sheldon Tauber (1955), 24 T.C. 179, (A) 1955-2CB9. This view has been rejected by the District Court of Delaware. See 10 Mertens Law of Federal Income Taxation, Zimet Rev., Sec. 58A.35, p. 98, n. 16.03, and also by the Ninth Circuit, Roybark v. United States, 9 Cir. 1955, 218 F.2d 164, 165, 166.

This Court has recognized that burden of proof to be a "settled principle of law"[5] or an "accepted principle."[6]

The Supreme Court, while holding the burden to be different in a proceeding before the then Board of Texas Appeals, has stated by way of dictum that in an action to recover taxes paid.

> "Obviously the burden was on the plaintiff, in order to establish a basis for judgment in his favor, specifically to show not merely that the assessment was erroneous but also the amount to which he was entitled."

Helvering v. Taylor, 1935, 293 U.S. 507, 514.

Finding no reversible error, the judgment is

AFFIRMED.

BROWN, Circuit Judge, dissenting:

I respectfully dissent.

This case shows that what is euphemistically called a "presumption" becomes an absolute to sustain the Commissioner's implied finding in the deficiency determination. In practical effect it puts the imprimatur of law on the unassailable character of a figure plucked out of the air by the Commissioner. I do not think that the presumption

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[5] United States v. Harris, 5 Cir. 1954, 216 F.2d 690, 691.

[6] Carter v. Campbell, 5 Cir. 1959, 264 F.2d 930, 937.

is intended to infuse that infallibility into the undisclosed[7] conclusions of this ephemeral agent.

The Taxpayer loses because he did not prove *how* much was attributable to the covenant not to compete. How could he when the parties did not? I assume it had some value. I would think it proper to find out what a *fair* value would be. Hence, my dissent is not an either or situation of total victory for Government or Taxpayer. There is still a place for a determination of that value. And the omnipresent, brooding presumption does not supply a substitute. Nor can it be sugar coated by the references to the equitable nature of a tax refund suit. Here in the name of equity the law puts its blessing on a fiat.

The Commissioner supposedly did two things. First, he concluded that because there was a difference between the sales price for the shares owned by Milwhite and those owned by David, the difference was attributable to the unique provisions of the David agreement. Second, based on the first he concluded that all of this difference was attributable to the covenant not to compete. I grant that this was certainly permissible as an administrative matter, and it put the burden on the Taxpayer to challenge it.

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[7] Actually, the Government changed its tune in the trial Court. Up to that time the Commissioner's presumptively correct conclusion was that the difference in sales price was attributable to a short term capital gain from David's sale of his option from Milwhite. Presumably when it got to the Department of Justice, that office thought that there was a better reason which the Commissioner must have unconsciously had in mind all the while.

But the uncontradicted facts of this record are revealing. The cash price was different. But so, too, was the other consideration. Thus, while Milwhite was willing to take $333,000 per 1,000 shares, it would do so only if the buyer would pay off the promissory notes for half a million dollars owed by Mud and which Milwhite had subordinated to a three-fourths of a million dollar debt owed by Mud to a Houston Bank. It is easy for this Court to say that Mud was "amply solvent." But solvency was not the concern of the parties. It could be solvent so far as the law's sterile test of paying off creditors if it liquidated. But that is not what bothered these businessmen. The company was woefully undercapitalized. It was hurting for working capital. As the Court points out, delay in payment of accounts receivable jeopardized its ability to continue in business. It was treading a narrow path with its banks. It was the considered judgment of these successful business men that more capital was needed. The way out was to sell all ownership stock to an outsider. Once that was to be done, Milwhite was unwilling to depend on the ability of the successor management to (a) pay off the bank debt first and then (b) pay off the notes owed by Mud to it.

The solution was to require the purchaser to pay off Mud's notes. Consequently, unlike the supposed determination of the Commissioner that Milwhite got $333,000 per 1,000 shares compared with David's $500,000, Milwhite got $333,000 *plus*. Surely, we cannot conclude that the agreement by Mississippi Fuel to pay this half million to Milwhite was worthless.

But this is not all. Taking the difference the Commissioner attributes it all[8] to the covenant.[9] On what basis is this done? How two sellers, each with different interests to serve, arrive at a price is a precarious basis for determining intrinsic attribution. Maybe one just wants more money. Maybe one thinks that the buyer will pay more. Maybe, as was true here, one (Milwhite) was bound under an option, the other (David) was a "free" agent vis-a-vis the new prospect. But how does the willingness to submit to a demand for more by one enable the Commissioner to say that *all* of the difference is due to the presence of these two pecular provisions of the David contract while ignoring the substantial unique provisions of the Milwhite contract?

I do not think the presumption can slide over all of these diffiicult economic and legal questions.[10] And with the facts all in, no factual basis is revealed to sustain the allocation for this amount. When that occurs, we have long held that the presumption no longer carries the day. *Phillips Estate v. Commissioner,* 5 Cir., 1957, 246 F.2d 209.

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[8] An adjustment was made from 166,000 down to $125,000, but this was from averaging the sales price of Milwhite and David sales. The difference of some 41,000 was not attributed to any feature of the David contract.

[9] Or perhaps in part the short term gain.

[10] See Mertens, §50.64-65.

APPENDIX B

IN THE
UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

No. 13,656

HENRY DAVID and wife, GRACE DAVID,
Plaintiffs

VS.

ROBERT L. PHINNEY, District Director of Internal Revenue
Defendant

* * *

FINDINGS OF FACT AND CONCLUSIONS OF LAW

(Number and Title Omitted) (Filed June 12, 1963)

This action having been tried by the Court without a jury, the Court hereby makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

1. This is a suit to recover $52,417.19 in income taxes and interest plus statutory interest as provided by law. This case was tried before the Court on April 17 and 18, 1963. Both parties filed briefs simultaneously.

2. The question presented is whether money received by the plaintiffs from Mississippi Fuel Corporation in 1956 included payment for an option to purchase stock and a

covenant not to compete in addition to the actual purchase price of the stock.

3. Henry David, hereinafter referred to as David or plaintiff, began working for Milwhite Company, Inc., hereinafter referred to as Milwhite, in 1938. Milwhite mined and manufactured drilling mud. After 1940, David became the exclusive selling agent for Milwhite and was paid on a commission basis. Between 1940 and 1952 David built an extensive sales organization which was founded primarily on his personal contacts and reputation in the industry. David was the dominant personality and key man in this sales organization. David was one of the most outstanding salesmen in the mud field.

4. On May 1, 1952, Milwhite and David organized Milwhite Mud Sales Company, hereinafter referred to as Mud Sales. Milwhite transferred its inventory and certain equipment to Mud Sales at the time of its incorporation and received certain notes in payment therefor.

5. From the date of the incorporation through 1957, Mud Sales successfully expanded its selling operations and the business grew at a rapid rate. In 1954 it became necessary to secure additional financing in order to cope with Mud Sales' rapid expansion of its selling operations. Milwhite obtained this financing from the Texas National Bank in Houston, Texas, by executing a loan subordination agreement whereby the notes received by Milwhite in payment for the inventory and equipment transferred to Mud Sales at its incorporation were subordinated to the Texas National Bank loan.

6. The growth of Mud Sales, as indicated by sales of Eight Million Dollars in 1955 and Fifteen Million Dollars

in 1956, necessitated further financing in the latter part of 1955 and the early part of 1956. At that time it became necessary to decide whether to curtail Mud Sales' expansion or seek additional financing. Mud Sales was able to secure a renewal of its note with the Texas National Bank, but was unable to secure additional money through other loans.

7. On October 1, 1955, David and Milwhite granted the W. R. Grace & Company an option to purchase all of the stock of Mud Sales. Milwhite agreed under this option to sell its 3000 shares of Mud Sales for One Million Dollars plus accrued net worth. David agreed under this option to sell his 3000 shares of Mud Sales stock for One Million Dollars plus accrued net worth. This option represented arm's length negotiation of the parties.

8. On December 2, 1955, Milwhite granted David a 90-day option to purchase its 3000 shares of Mud Sales stock for One Million Dollars plus accrued net worth. This option was made subject to the outstanding option held by W. R. Grace & Company. W. R. Grace & Company failed to exercise or extend its option, and David's option became effective on December 2, 1955.

9. Mississippi River Fuel Corporation, hereinafter referred to as Mississippi, became interested in Mud Sales in December of 1955, and in January, 1956, a meeting was held in Palm Beach, Florida, for the purpose of discussing a merger of Mud Sales with MOBAR, a subsidiary of Mississippi which was competitive with Mud Sales. The negotiations with David at the Palm Beach meeting were handled on behalf of Mississippi by Mr. Marbury and Mr. Bolinger. Mississippi would not have considered buying Mud Sales without securing David's organization and

services in its operation, because David was the key man and dominant personality in Mud Sales.

10. David's negotiations with Mississippi ultimately culminated in the execution of a contract dated February 7, 1956. This contract was initially drafted by David's attorney, who discussed each provision of the contract with him in detail. The draft of the contract was forwarded to Mississippi and returned with several changes, one of which was the addition of Paragraph M of the contract of February 7, 1956. Paragraph M of the agreement of February 7, 1956, reads as follows:

> M. One of the considerations entering into the purchase price being paid and to be paid for all of said capital stock, is the good will attached to the operations of MUD SALES under the management of DAVID. Accordingly, as an essential part of this Agreement DAVID agrees not to engage in any business or activity in any way competitive with MUD SALES for a period of two (2) years from the date of purchase by MISSISSIPPI of said remaining 2,000 shares and in no event prior to February 1, 1961.

David's attorney reviewed the contract as proposed by Mississippi and discussed each of its provisions, including Paragraph M, with David, who understood these provisions.

11. The contract of February 7, 1956, which was executed by all parties to the negotiations, incorporated all of the agreements of the parties as negotiated by David.

12. The contract of February 7, 1956, essentially provided that David would assign and Mississippi would

exercise the option of December 2, 1955; that David would sell and Mississippi would buy 1000 shares of Mud Sales stock from David; and David granted, as an individual and as guardian, an option to Mississippi to purchase the remaining 2000 shares of Mud Sales stock.

13. In the agreement of February 7, 1956, Mississippi simultaneously acquired control of Mud Sales, a right to purchase all of the outstanding shares of Mud Sales, and a covenant by David not to compete for at least five years. This agreement also provided an alternative sales price for the 2000 shares covered by the option given by David to Mississippi. In the event that David was unable to perform the duties he had been performing as president, or in the event David died, Mississippi agreed to purchase the 2000 shares of Mud Sales covered by the option for a price equal to 2/3's of the payment made to Milwhite under the option of December 2, 1955, plus accrued net worth. David negotiated this alternative valuation with Mississippi.

14. All of the provisions of the contract of February 7, 1956, were carried out by the respective parties insofar as practicable at the time. David assigned the 90-day option of December 2, 1955, to Mississippi. Mississippi exercised the option of December 2, 1955. David transferred and Mississippi received 1000 shares of Mud Sales stock from him. A guardian was appointed on behalf of his children, and the option to purchase their 1000 shares was agreed to in a contract dated July 10, 1956, which provided for the sale of the children's stock at $1250 a share or an alternative valuation in the event David became disabled in the amount of $333.34 per share plus accrued net worth. This option agreement was approved

by the Probate Court of Harris County, Texas, as representing a fair price for the stock. The option of December 2, 1955, which David assigned to Mississippi gave Mississippi the right to purchase 3000 shares of Mud Sales stock at $333.34 a share plus accrued net worth. This was a valuable property right.

15. The covenant not to compete, set forth in Paragraph M of the contract of February 7, 1956, was negotiated by David as a part of this agreement and was a valuable consideration supporting the contract of February 7, 1956.

16. David reported the $629,226.75 received from Mississippi on February 16, 1956, on his income tax return for 1956 as long-term capital gain from the sale of Mud Sales stock.

17. Part of the $629,226.75 paid by Mississippi to David represented payment for the assignment of the option dated December 2, 1955, which was a valuable property right, and payment for the covenant not to compete given by David was an essential part of the agreement of February 7, 1956.

18. The evidence indicates that there was no mistake in the provisions of Paragraph M of the contract of February 7, 1956. The express terms of this contract govern and establish that a covenant not to compete was a part of the contract and that a part of the purchase price was paid for the covenant. The evidence is clear that the covenant not to compete was separately dealt with. The only evidence concerning what was paid for the covenant is plaintiff's testimony that he was paid nothing for the covenant. The overwhelming evidence contradicts plaintiff's statement.

CONCLUSIONS OF LAW

1. This Court has jurisdiction over the parties and subject matter.

2. The total consideration for the contract of February 7, 1956 must be allocated to its component parts.

3. Part of the consideration was paid to the plaintiff for assignment of the option of December 2, 1955.

4. Part of the consideration was paid for plaintiff's covenant not to compete. Plaintiff has failed to offer any credible evidence tending to prove that the determination of plaintiff's federal income tax liability by the Commissioner of Internal Revenue was wrong.

5. Plaintiff has failed to offer any credible evidence from which any other determination of plaintiff's federal income tax liability could be made.

6. Judgment should be entered in favor of the defendant and the plaintiffs' complaint should be dismissed with prejudice and the Government should have its costs. "handwriting"—June 12, 1963.

/s/ Joe Ingraham
United States District Judge

"handwriting"—Notify counsel to draft and submit judgment accordingly.